

Submission by the Seventh Day Adventist Church

Rodney Brady
Chief Financial Officer
South Pacific Division of the SDA Church
Locked Bag 2014
Wahroonga 2076, NSW
Phone: (02) 9847-3333
rbrady@adventist.org.au

to

Australia's Future Tax System Review Panel

AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

**DEDUCTIBILITY OF GIFTS TO CHARITY
A CONSISTENT APPROACH**

Overview & Summary

- Charity, like governments, serves public purposes. Charities have enjoyed the favour of the law since the Middle Ages because they are as much a part of the social fabric as any public institution. The law of charity has always had a public benefit test.
- Unlike governments, charities do not raise funds by taxation but through donations and their own investment or trading income.
- But just as governments cannot be, and are not, taxed (which would be self-contradictory), so charities, as public-serving bodies, should not be either. Unlike commercial companies, charities do not exist to pay dividends to private owners but to serve the public benefit. Their donations, income and funds are reserved for public benefit. Any comparison for a “level playing field” in tax terms has to be with government itself.
- Since charities do not tax, and must rely on voluntary donations, the tax system should free these funds from taxation by allowing deductibility and exemption to charities on a consistent basis. This is largely done in the USA, NZ, Denmark and the UK.
- The Federal Government has commendably broadened deductibility for philanthropic gifts of property and has encouraged employers to offer payroll deduction for deductible gifts.
- It is consistent with this approach for deductible status to be recognized for all charitable gifts. This would remove anomalies so that gifts to churches would be on the same basis as the many other charities they sponsor and support. General gifts to primary and secondary education would be on the same basis as gifts to school building funds and universities.
- Non-discriminatory tax treatment for all charities would be consistent with the recognition by the Charities Inquiry into the definition of charity that the general concept of charity remains relevant to Australian society.
- Using charity as a unifying concept for tax deductibility and tax exemption has administrative clarity and even-handedness. Charities cannot be political. The public benefit test for charity allows a plurality of worthwhile causes in a liberal democratic society while insisting that mere lobbying or political advocacy are not charitable.
- There are sound economic benefits from general exemption and deductibility for charity. Economic efficiency is improved as increased donations enable charities to complement public spending in meeting society’s welfare needs more sensitively and efficiently. At a time when governments of all political persuasions recognize the merit of public-private partnerships and encouraging self-sufficiency (eg through superannuation tax deductions), it is logical to put deductibility and exemption for charities on a common basis.
- Contrary to what is sometimes said, tax exemptions or deductibility for charities do not involve unjustified tax concessions or “tax expenditures” or departures from competitive neutrality. A “tax expenditure” can only be defined against a neutral tax system and competitive neutrality can only be defined when “all other things are equal”. It is actually necessary to give exemptions or deductibility to charities to ensure neutrality towards non-commercial, non-government altruism.

Introduction

The South Pacific Division of the Seventh-day Adventist Church is the regional coordinating office for the Church. Its territory includes Australia, New Zealand, Papua New Guinea and other South Pacific countries as far east as French Polynesia. Within this geographic area are various constituent bodies of different legal and administrative status.

The activities of the Church in Australia in this region include the ecclesiastical functions of the Church; K-12 schools; tertiary education; Aboriginal education facilities and health programs; aged care; the promotion of health and wellness through the activities of Church's hospitals and Sanitarium Health Foods; printing and publishing; Christian book shops; national and international welfare, development and aid agencies

The Church welcomes the opportunity to engage in dialogue with the Panel on the important subject of tax and a fairer tax treatment for religion and charity.

In 2008, New Zealand commenced a Charities Commission and at the same time made all donations to all registered charities subject to a rebate. Unlike developed countries such as the USA, Canada, New Zealand, Denmark and others, Australian tax policy does little to encourage charitable giving. We are pleased to recognize the steps taken in Australian tax administration to encourage PAYE-adjusted payroll giving by wage and salary earners to deductible gift recipients.

We believe the Government has been right to recognize the role that charities can play in reducing excessive reliance on government social services. We further believe that religion and charity are fundamental pillars of civil society.

This submission should therefore be seen as consistent with, and embracing the logic of, previous government initiatives and putting them within a holistic approach to charity as part of the fundamental social and economic infrastructure of this nation.

Background

Income tax "concessions" for charity have been in Australia's tax laws from their inception. These concessions can be traced back, like many other things, to the United Kingdom.

The word "concession" is perhaps unfortunate. In its common usage, especially by treasury officials or some academic writers, it has acquired a pejorative tone implying that a concession is really an unjustified allowance for human weakness or illogical public sentiment. However, its original sense meant a justified allowance for the circumstances of the particular case.

A key thrust of this submission is that income tax "concessions" for charity are a proper, necessary and entirely logical part of any income tax system and are only to be understood as "concessions" in the strict sense that they are necessary allowances to integrate an income tax into the circumstances of a pre-existing civil society where charities already exist.

The idea that tax concessions for charities are "subsidies" or "tax expenditures" is one which has deplorably infected much writing on the subject. It has no real basis other than assertion. Nonetheless, because of its influence, the logical defects of this viewpoint are subjected to closer scrutiny in Appendix II below.

This submission argues that it is logical, appropriate and in accordance with accepted political and economic theory that all income of all charities be exempt, whether from investments or business or donations and that donations to charity, whether in cash or property, should be tax-deductible.

Accordingly, the income tax law should be amended so that all tax-exempt charities are included as deductible gift recipients.

At present, many charities, including churches, have specific funds which are deductible gift recipients.

However, the parent charity may not be designated itself as being a deductible gift recipient. This is not only illogical but causes administrative costs for charities, confusion for donors and difficulties for the ATO itself (eg persons participating in ATO-recognized workplace giving programmes may not appreciate the subtle differences).

GST and fringe benefits tax changes have created major administrative costs for charities. The sector is now heavily regulated and faces the prospect of duplicated regulation by a charities commission and further ATO review. All these administrative costs create overheads which eat into funds which should be directed to charitable activity. If a charity has passed all the existing administrative requirements imposed by government and is seen to be *bona fide*, it is reasonable for government to accept that a charity should not have to incur further wasteful administrative costs in maintaining separate deductible gift funds: the tax-exempt charity should be recognized directly as being a deductible gift recipient.

The meaning and history of charity

While some would argue that the existing legal definition of charity is a “horse and buggy” definition which has not been updated since the statute of Elizabeth of 1601, this is merely an assertion which must be tested against history, experience and reflection.

The UK Nathan Report (1952, p 31) recognized “For practical purposes the Courts have for many years accepted the classification of charities and made by Lord Macnaghten in the Pemsel case as a restatement of the preamble in modern terms. The passage in Lord Macnaghten’s speech in that case runs as follows; –

“‘Charity’ in its legal sense comprises four principal divisions: trusts for the relief of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community, not falling under any one of the preceding heads”.

He added “the trusts last referred to are not the less charitable in the eye of the law, because incidentally they benefit the rich as well as the poor, as indeed, every charity that deserves the name must do either directly or indirectly”.

There are two points of major importance to note in Lord Macnaghten’s definition. First, that the definition was not closed; as Bradshaw (1983) documents, there is a wide range of charitable objects which could come into the definition depending on social conditions and the emergence of new areas of need; for example psychotherapy in marriage counselling was unknown in the 19th century and its emergence illustrates the value of research and education in serving real human needs. Second, Lord Macnaghten was well aware that charities benefited - and should benefit - all social classes.

One also notes that religion was central to the definition; this is not surprising as charity in Western culture springs from the concept of Christian charity and good works. Thus universities, schools, hospitals and poor relief by monasteries in pre-Reformation Europe were all Church activities. This tradition largely continued after the Reformation and universities such as Harvard and Princeton were founded as theological seminaries much as Oxford and Cambridge had been founded before.

That the traditional English definition of charity clearly owes much to the Christian religion is emphasized by legal history. As Dal Pont (2000, p 44) notes, the mediaeval Church was the main agency sponsoring all kinds of charitable activity before the Reformation. From early times, gifts to charity were fostered by the Ecclesiastical Courts and by the courts of Chancery (the Chancellor was an always an ecclesiastic until Sir Thomas More). As the Nathan Report (1952, p 16) notes “Indeed, in the absence of expressed directions in wills it was understood that the residue should be expended on pious and charitable works.” There were, of course, ancient examples of philanthropy: for example, Plato bequeathed his Academy to his successors with an endowment of productive land, the Ptolemies endowed the library of Alexandria and the younger Pliny a school in his native town.¹

¹ Kutner (1970, p 16)

Despite these ancient examples of philanthropy, the ancient world had not been particularly solicitous of the ignorant or the poor. Slavery, destitution and ignorance were usually regarded as the fate awarded the common man by the gods. The Christian concept that all men were equal in the sight of the creator was quite novel. Aristotle himself had said that some men were born to the slaves. The Roman republic drew clear distinctions between plebeians and patricians, freedman and slaves. The Christian idea that it was laudable for an educated upper-class person to mix with slaves or freemen and seek to educate their children or tend their sick was novel: individual bonds there might be between master and servant, but there was no general concept of inherent equality.

This religious concept of the inherent worth of each and every individual has profoundly influenced Western civilisation. Western European civilisation since the conversion of the Roman Empire, has held to the ideal, if not the practice, that each and every person is precious and that charity, (which at base means love), consists of aiding persons in mind, body and soul. Hence charity was never confined to aiding the poor, it naturally and always extended to instructing the young and ignorant and aiding the sick, be they rich or poor.

Interestingly, modern concepts of human rights of man are rooted in the same religious convictions which established charity in Western civilisation.

Nor should it be forgotten that other great religions and civilizations have recognized the importance of almsgiving or scholarship. As the Nathan Report noted (1952, p 7, para 34) "Historically, it is the religious motive which has been primarily responsible for widening the bounds of good neighbourliness and the obligation to meet human need. Though frequently neglected in practice, such tenets lay at the heart of the more ethical religions of the past, as well as of the great living religions of today. The command to love one's neighbour as oneself goes back to the earlier days of Judaism. The extension of that command without qualification, 'There is neither Greek nor Jew, circumcision nor uncircumcision, Barbarian, Scythian, bond nor free', was part of the motive force of primitive Christianity. The obligation of almsgiving is emphasised in the Koran and Buddhism and Hinduism are deeply imbued with a sense of the oneness of mankind." For example, in Islam is to be found the *waqf*, an institution governed by religious sanction and which resembles a combination of a family trust and a charitable trust.²

It is important to note that, whether in its religious or secular form, the concept of charity arises from the concept of the natural worth of the individual human being rather than from any utilitarian calculus, which perhaps explains why economic analysis based on wealth-maximizing behaviour has not been notably successful in analysing charity as an economic reality. The philosophical background of modern welfare economics rests on neo-utilitarianism and the utility maximising behaviour of individuals and has difficulty dealing with concepts such as altruism, voluntary gifting of income or moral duty.³

Most economic modelling essentially ignores the voluntary redistribution of income or the voluntary provision of social services or social goods, including the most precious social good of all - the mutual trust and confidence of members of society in each other.

Charity, resting as it does on different philosophical foundations, cannot be easily fitted - if at all - into models of utility maximising market exchange or social choice by rational self-interested individuals. Simple economic models of identical, adult, producers and consumers, with perfect information and fixed preferences, living in a world of atomistic exchange can shed little light on the social or economic reality of charity. Such models take certain social facts for granted, often without realizing that they are doing so.

Yet just because altruism and charity are not easily modelled by economists does not mean they are of no socio-economic importance or should not be considered in the formation of taxation policy.

² Kutner (1970, p 18). It is interesting that the support of one's family as a moral duty is placed together with the duty of charity.

³ But Adam Smith, the father of economics, was *not* a narrow utilitarian in his thinking and fully recognized benevolence and sympathy in his theory of morality.

Indeed, the importance of religion and charity for economic or civil society can hardly be overstated. Every day, it is religion which binds people on oath in the Courts of this country. How would governments collect taxes or administer laws if citizens did not obey the commandment not to lie? What would Budgets be like if people were told marriage vows meant nothing and there was no obligation to render unto Caesar what is Caesar's? The Courts and the administration of justice do not depend on force and coercion so much as the voluntary obedience of citizens which rests, for many, upon the moral habits arising from their religious upbringing.

It is instructive that the first President of a modern liberal democratic society, George Washington declared in his farewell address of 1796 that "Of all the dispositions and habits which lead to political prosperity, religion and morality are indispensable supports. In vain would that man claim the tribute of patriotism, who should labour to subvert these great pillars of human happiness, these firmest props of the duties of men and citizens. The mere politician, equally with the pious man, ought to respect and to cherish them. A volume could not trace all their connections with private and public felicity. Let it simply be asked; where is the security for property, for reputation, for life, if the sense of religious obligation deserts the oaths which are the instruments of investigation in courts of justice? And let us with caution indulge the supposition that morality can be maintained without religion. Whatever may be conceded to the influence of refined education on minds of peculiar structure, reason and experience both forbid us to expect that national morality can prevail in exclusion of religious principle.

It is substantially true that virtue or morality is a necessary spring of popular government. The rule, indeed, extends with more or less force to every species of free government. Who that is a sincere friend to it can look with indifference upon attempts to shake the foundation of the fabric?"

The United States recognizes the separate, yet co-ordinate, positions of state and religion by allowing full deductibility of all charitable gifts (including to religion, which is the wellspring of charity) and tax exemption for all kinds of philanthropy. Deferred gifts of property and securities are also allowed.

What happens when charity ceases to exist?

It is commonplace today for people to admire the strength and vitality of US non-profit institutions and their role in US culture, education and healthcare. The American colonies took a liberal view of charity. Indeed, Massachusetts and Pennsylvania led the way by incorporating in their first post-colonial constitutions express recognition and encouragement of charitable purposes including the encouragement of public and private educational institutions.

But the United States furnishes another and even more valuable lesson, for those who might argue for restricting or taxing charities. In 1819 in the case of *Philadelphia Baptist Association v. Hart's Executors*, the United States Supreme Court struck down a charitable bequest on the basis that the court's jurisdiction in charity cases originated in the Statute of Charitable Uses which had been repealed by the Virginia legislature in 1792. The result was that, in the United States, charitable gifts, other than to incorporated bodies, failed and many grasping heirs gained what had been intended for charity. By the 1830s, Virginia itself was seeking to reverse the anti-social effect of the Hart decision by both judicial and legislative action to try to save charitable gifts, including for educational purposes.

Fortunately, the American experiment in eliminating general charitable bequests was reversed by the Supreme Court in a famous case which vindicated the validity of the will which established the Girard School for orphans in Philadelphia. With the benefit of the publication in 1827 by an English Records Commission of unreported Chancery cases dating from the Middle Ages, the United States Supreme Court was able to acknowledge that the law of charity rested on case law rather than statutory foundations and dated well before the Statute of Charitable Uses of Elizabeth.⁴

⁴ A fascinating account of the 1819-1844 American experiment in abolishing charitable trusts is set out in Miller (1961)

Curiously, in New York, the State Supreme Court continued to hold that charitable trusts had been abolished by a specific State codification of 1829 which had abolished all uses and trusts of land except those specifically authorised. In 1891, the failure of a legacy of almost \$4 million left by Governor Tilden to found a free library in New York City led to a public reaction against the ban on charitable trusts culminating in the passage of the "Tilden Act" in 1893 which declared that charitable trusts should thereafter be valid. Subsequent amendments restored the entire doctrine of charitable trusts to New York.

The American experience dramatically illustrates the value of charity and the potential loss to the community were charities to cease to exist or be taxed out of existence.

Political theory

In common with the United States of America and United Kingdom, Australia has inherited the common law and its associated concept of representative government. It is implicit in our theory of political society that the citizen is not the property of the state and that there are pre-existing natural institutions and natural rights. As the 17th-century philosopher John Locke argued in his *Two Treatises on Government*, Parliaments do not come as legislators to a clean slate. The common law, with its associated law of charities, has existed for hundreds of years and many charities in this country are older than either the Commonwealth or its income tax legislation.

Essentially, it should be recognized, as the Americans have recognized, that charity forms an essential part of the social fabric which binds society together. Only Communist or extreme Socialist regimes would take the view that there should be nothing between the State and the individual and that there is no role for intermediating social structures such as family and charity. Indeed, one of the greatest problems in re-creating full civil societies in Eastern Europe has been the over-dominance of society by government to the exclusion of voluntary associations and charities.

Pre-existing civil institutions such as the family and charities serve social needs just as much as governments. Wise legislators have always recognised this and have followed a principle of subsidiarity which seeks to respect and acknowledge the separate and pre-existing roles of other social institutions. No Federal Government, for example, could ever seriously contemplate taking over roles of families, churches and State, local and municipal governments and even the most centralised of foreign nations have found devolution a practical necessity.

Turning more particularly to those civil institutions serving collective needs, these usually constitute local government bodies or charities. Practical respect for these other civil institutions is reflected in the principle that state and local governments and charities are not subject to Federal income tax. Just as one level of government should not frustrate another, so governments should respect the role of charities as equally legitimate institutions serving social needs.

Economic theory

Public choice theory in economics points to the notion that governments are like clubs in the sense that they can provide members of society with services beyond an individual's capacity. For example, social security systems can be explained as forms of collective or mutual insurance (at least in their origins).

But governments, unlike clubs, have coercive taxation powers. Taxation is designed to redistribute funds from private individuals to public purposes (eg education) or towards needy individuals.

Charities do much the same thing. Charity, by legal definition, exists for the public benefit and redistributes income from donors towards its purposes which include the relief of poverty and the advancement of education.

The difference is that charities achieve their public purposes through voluntary gifts and endowments, not through taxation.

As economists (and most other people) know, taxation usually creates economic distortions and disincentives.

Taxation always involves economic costs. Hence there is a strong economic presumption in favour of meeting social needs through voluntary funding of charities before resort to public provision through taxation.

This observation furnishes a central economic argument (complementing the political theory argument of subsidiarity) in favour of general tax exemption and tax deductibility for charities.

Tax deductions for charity allow a kind of “free market” in letting taxpayers get the overall pattern of social welfare, broadly defined, which they wish. Some people prefer to support art museums, some prefer overseas aid, some prefer schools but all are given a free choice. It is a commonly accepted view that society works more harmoniously and efficiently when people are able to express their personal decentralized economic choices instead of being subject to the centrally commanded economic decisions of bureaucracies. This economic efficiency argument parallels the argument that a liberal democratic society recognizes pluralism and differences in preferences as natural and to be expected. Such a society looks for ways to foster its citizens’ initiatives in every area of public improvement and tax deductions for charity are just one example of such creative pluralism at work.

The definition of charity is appropriate as recognising things which it is in the public interest to undertake. These voluntary forms of meeting community needs should not be impeded or “crowded out” by public sector taxation and expenditure systems. Taxation is a form of economic penalty. Why penalise the voluntary allocation by individuals or businesses of their income towards meeting socially worthwhile needs?

(Parallel economic arguments are often used - and accepted - in relation to even merely private expenditures. For example, tax concessions are given for superannuation contributions and health insurance premiums because government has a legitimate vested interest in ensuring less dependency on taxpayer funded age pension or hospital systems.)

Income taxation theory

Turning from the more abstract political and economic theory arguments in favour of general exemption and deductibility for charities, it is worth noting more precisely how the theory of personal income taxation itself points to general exemption and deductibility.

Henry Simons, the Chicago economist, in his oft-cited book *Personal Income Taxation*, argued that income was consumption plus accumulation. On this definition, it is logical to allow deductibility of charitable gifts since income transferred to a charity is not available for a taxpayer’s personal consumption or as in addition to personal wealth. For example, under the United Kingdom tax system, the principle of recognizing income transfers has historically been achieved by allowing deduction of moneys paid under a covenant of gift. In Australia, for example, the tax system recognizes income transfers where a contribution made to a superannuation fund is deducted from the income of the contributor and treated as the income of the fund instead.

The basic idea behind income tax is that individuals should be taxed on the income *they actually enjoy themselves* rather than simply on income received. Any logical income tax system requires that income be taxed once, and once only, and in the hands of the ultimate beneficial recipient. Recognizing income transfers to charity is consistent with this principle of tracing income to the ultimate recipient.

This basic principle is recognized with business or investment income but not with wage or salary income. For example, taxpayers with property or business income can already enjoyed the equivalent of tax deductibility for their charitable contributions simply by making a charity a beneficiary of partnership or trust distributions or of company dividends.

Furthermore, many businesses claim deductions for charitable gifts under the ordinary business deduction provision on the basis that sponsoring charity and being seen to be a good corporate citizen is a legitimate business expense. But a wage or salary earner cannot claim a business deduction for such charitable gifts.

The result is that the present limitations on general tax deductibility for gifts to charity discriminates against wage and salary earners who want to make gifts from their income to charities which may be tax-exempt but do

not have tax-deductible status. For example, an employed computer consultant cannot deduct a gift to his or her church but a self employed computer consultant operating through a partnership or trust can do so by arranging a distribution from the business entity. This is an unfortunate discrimination since corporate charitable giving is necessarily limited by the obligation of directors to make profits for shareholders rather than give money away to charity. There is a real need to ensure that giving by the person in the street is not discouraged. The existing anomaly and inequity can be removed by treating all tax-exempt charities as deductible gift recipients.

It is really quite anomalous that churches, as tax-exempt charities, are excluded from deductible gift status. Religion is the *fons et origo*, the fountain and source, of charity. It is precisely because charity in Western civilization finds its origins in the Christian gospels, that religion has always stood within the legal heads of charity. The historical origins of charity in religious conviction, and the continuing relevance of that belief in the activities of the Churches across a range of activities from schools, to hospitals, to welfare, to drug rehabilitation, to marriage counselling - across the whole range of human need - mean that charity in all its forms must be dealt with consistently for tax purposes. Many donors to churches take it for granted churches will use funds for a range of charitable purposes.

Conclusion

It has been recognized for years that it is anomalous that not all tax-exempt charities are deductible gift recipients and that it is illogical, for example, that a general gift to a university is deductible but a gift to a school or church is not. It has also been recognized as inequitable that a high-income taxpayer can gift pre-tax income through a trust or business to a charity but a wage or salary earner cannot.

Religious and other tax-exempt charities should be included as deductible gift recipients. There is every reason of logic and policy for doing so. If a charity is exempt on its income (as it should be) then transfers of income to it should be equally deductible.

APPENDIX I

PREVIOUS REPORTS ON INCOME TAX TREATMENT OF CHARITIES

Asprey Report 1975

The 1975 Asprey Report, arising from the review of taxation in Australia by the Taxation Review Committee (the Asprey Committee), examined the taxation treatment of charities as part of its comprehensive taxation policy review.

While the Committee was perhaps overly influenced by the then novel terminology of “tax expenditures” or “tax subsidies”, it did not, in fact, recommend removal of tax concessions for charities, recognising instead that these could be justified and that there were problems for charities.

The Asprey Report recognised there was a lack of uniformity between tax exempt and deductible status for charities and that one of the chief problems was that deductibility did not extend to religious bodies.

The Asprey Report discussed tax concessions and various types of subsidies, concluding that “charities are non-profit organisations with little or no income apart from investment income.” The exemption of investment income of a charity “can be justified as flowing from the encouragement to donors to give to charities” while the deduction system for gifts should be retained in the absence of any evidence to assuage fears of reduced giving if it were to be altered.

Industry Commission 1995

A major aspect of the 1995 Industry Commission report on charities was their tax treatment. The terms of reference of the Inquiry specifically requested the Industry Commission to report on “the appropriateness of the present taxation treatment of charitable organizations”.

The Industry Commission report on charities was, from a tax viewpoint, in some respects a pleasant surprise.

The Industry Commission recognized in 1995 that:

- the tax exemption of charities is not an unfair commercial advantage;
- the exemption of unrelated business income does not lead to unfair competition with commercial competitors, since it would not be rational for a charity not to maximize its profits for its charitable purposes;
- the restrictions on tax deductibility to public benevolent institutions is discriminatory as regards other charities;
- tax deductions should not be capped; and
- the capital gains tax on assets bequeathed to charity is irrational and should be repealed.

We have used the term “charity” although, strictly speaking, the Commission’s terms of reference limited it to charities in the social welfare field. But the Commission’s recommendations cannot be so limited, given the close links between various kinds of charity.

It was particularly notable that the Industry Commission steered away from any suggestions for restricting the tax exemption or tax deductibility of donations to charities. This is perhaps one of the few occasions where an inquiry within a Treasurer’s portfolio has recommended maintenance or extension of what Treasury describes (usually with a pejorative tone) as “tax concessions” or “tax expenditures”.

Report of the Inquiry into the Definition of Charities

The Inquiry into the Definition of Charities in 2001 discussed the issue of the tax treatment of charities as it pertained to competitive neutrality. The Committee rejected the argument that the income tax exemption for charities caused unfair competition with for-profit organisations.

The Inquiry recommended some extension of the concept of charity (eg to recognize more fully cultural, environmental and human rights purposes) and accepted that religion properly remained within the primary heads of charity.

The Report of the Inquiry recognised that:

- For-profit business organisations can raise money in capital markets by issuing shares and by entering loan agreements. Not-for-profits are not able to raise money in the capital markets through equity or debt.
- Not-for-profits must rely on government grants, donations, or funds generated by their commercial activities. Thus, the Inquiry did *not* accept the notion that charities have an unfair advantage over for-profit organizations.
- The “unfair competition” argument was weak because charities do not have income in the sense used in the taxation laws: charities do not have profits to distribute to shareholders or members. The funds of not-for-profits are devoted to the provision of services.
- Since charities cannot raise equity or debt in capital markets, generating a surplus from commercial activities was the only way to get reserves to undertake capital works or long-term commitments.
- Tax exemption did not give unfair advantage to not-for-profits, given their limited scope for fund-raising.
- Competitive neutrality should not be a factor in defining a charity: “It would be inappropriate for the definition of a charity to change because other sectors of society engage in activities previously undertaken only by charities...if they (charities) retain their characteristics of being not-for-profit and with a dominant purpose that is charitable, altruistic and for the public benefit.”
- Commercial activities are acceptable when not conducted for the profit or gain of any particular person or group of persons. If the dominant purpose of the organisation is charitable, then any other purposes must further the dominant purpose, or be in aid of it, or be ancillary or incidental to the charitable purpose.
- Charities are compelled to find innovative ways to raise funds: “Conducting commercial enterprises as a fundraising operation can be an important, at times essential, element in enabling a charity to achieve its charitable purpose.” The Government itself sought to foster partnerships between the community and for-profit sectors.

Summary Outcome

No independent inquiry into the income tax treatment of charities has recommended either restriction or removal of tax exemption for charity, nor recommended abolition of deductions. On the contrary, anomalies have been recognized including the problem of exempt, but non-deductible, religious charities. Further, the most recent inquiry into the definition of charities has found that the definition of charity should be somewhat less narrow in certain respects.

APPENDIX II

ARGUMENTS RAISED AGAINST TAX “CONCESSIONS” FOR CHARITIES

The “Tax Expenditure” Argument Against Charities

The question which has been raised from time to time is whether charities and their donors deserve the so-called “tax concessions” they enjoy. Should these tax “concessions” be replaced by direct Budget funded grants to secure a more efficient and publicly accountable outcome for the “assistance” given hitherto by tax concessions?

It has been the received bureaucratic wisdom that efficiency and equity will be improved if so-called disguised “tax subsidies” for charities are replaced by direct Budget grants. But does it really make sense that centralized decision-making is superior to decentralized decision-making by donors and the charities they support? Are large bureaucracies more sensitive to community needs and aspirations where people live? If centralized, departmental, decision-making has been abandoned for public economic enterprises, why should we expect it to work better at the more complex, social and inter-personal level on which charities operate?

The Concept of a Tax Expenditure

Any argument for replacing tax assistance with direct subsidies has to start with the assumption that tax exemptions for charities and tax deductions for charitable gifts are indeed subsidies. The jargon is that they are tax expenditures - a handout of public money through tax concessions.

Richard Krever argues “In effect, the *Income Tax Assessment Act* consists of two separate systems. The first is the revenue raising system based on a neutral revenue raising tax base. The second is an expenditure programme. This part of the Act has nothing to do with collecting revenue. Rather, it is the spending side of the tax system, the short cut for direct expenditures.”⁵

In this statement, Krever states that many provisions of the *Income Tax Assessment Act* (ITAA) are tax expenditures. Put simply, a tax expenditure exists whenever the government assists any activity or person through a concession or allowance in the tax system which deviates from a neutral or benchmark system, instead of using budgetary outlays. The tax expenditure concept is a mode of analysis - a tool for identifying and accounting for disguised expenditures, whatever their purpose. As Treasury in its 1986 Tax Expenditures Statement puts it, tax “concessions reduce or delay the receipt of taxation revenue and... represent a call on the Budget similar to direct outlays. Because their effects on the Budget and on beneficiaries are comparable in many respects to the effects of direct outlays, and because the benefits provided by many of the concessions could conceivably be provided alternatively by direct expenditures, such concessions have come to be referred to as ‘tax expenditures’.”

The tax expenditure concept was first promoted in the United States by Stanley Surrey and has been copied in other countries including Australia, Canada and the UK.

The Importance of a Benchmark for Defining Tax Expenditures

Since a tax expenditure is *defined* as a deviation from a benchmark or neutral (which may not be the same thing) tax system, it is first necessary to define and examine the benchmark tax system before one can see whether anything is a tax expenditure or not.

The choice of the benchmark income tax system requires decisions as to what is the normal treatment to be adopted for many aspects of the system, including:

⁵ Richard Krever “Structure and Policy of Australian Income Taxation” in Krever, Richard (ed.) *Australian Taxation: Principles and Practice* (1987) p 10. Krever was later a consultant to the ATO in relation to its submission to the Inquiry into the Definition of Charity.

1. The rate scale (including the tax-free threshold):

Is the tax-free threshold a “tax subsidy”? Generally, the legislated income tax rate scale is taken as a given benchmark.

2. The treatment of entities such as partnerships, trusts or companies:

Should entity income be taxed twice or taxed only where it ends up? Before 1982 the “double taxation” of company dividends received by individuals was treated as part of the benchmark tax system: in 1988 the imputation system was treated as the benchmark and hence credits for franked dividends are not treated as tax expenditures. This example of a change in the Treasury definition of a “tax expenditure” shows how the term all depends on one’s prior assumptions. It is now accepted that the proper conceptual benchmark is that all income should be allocated to persons before imposing tax. Artificial entities do not pay tax - people do. Thus income is allocated through these entities and taxed in the hands of the ultimate beneficiary.

3. The nature of income:

Henry Simons defined personal income as consumption plus accumulation. If by consumption we mean the flow of satisfactions we receive from goods and services, should we count as income the benefit of public amenities such as parks or gardens? If we do not count these as income when provided by the public sector should we count them as income to the public when provided by charitable trusts? Generally the view is taken that income does not embrace public goods available to all such as defence or national parks etc.

4. The treatment of private income transfers, that is, voluntary private income redistribution:

Generally, it is accepted that property income can be diverted to another person or charity but not wage or salary income. This may be questioned. Who is the proper taxpayer? - the person who drives the income or the person who gets to actually enjoy the goods and services yielded by its spending? On Henry Simons’ view one should tax income in the hands of the person who gets to enjoy it, unless one is willing to argue that giving money away is spending it. It is crucial to decide whether income tax should be levied on income gross or net of private income redistribution.

All these assumptions are relevant to the correct tax treatment of charities.

The Benchmark should be Neutral

One point to be observed is that the benchmark tax system should be a neutral tax system. If one can demonstrate that the chosen benchmark is not neutral, then the whole rhetoric of a “level playing field” falls to the ground with a heavy thud. After all, if one chosen non-neutral tax system is good enough for a benchmark, why not any of a thousand other non-neutral alternatives, including a few tilted in favour of the taxpayers?

History of the “Tax Expenditure” Concept

The tax expenditure concept was pioneered in the USA by Professor Stanley Surrey of the Harvard Law School. While in the US Treasury, Surrey was struck by how often lobbyists succeeded in getting by way of tax concession what they could not get by direct appropriation. The result was his book *Pathways to Tax Reform*, which pushed the idea that tax cuts across the board could be financed by wiping out tax expenditures. However, to be fair to Professor Surrey, many of the tax provisions he attacked were the result of Congressional “logrolling” and could not be justified on any reasonable tax principles. But not all were so devoid of merit and other scholars did not necessarily accept his ideas wholesale.

The tax expenditure concept was first used in Australia by the 1973 Coombs task force on continuing expenditure policies of previous government which was commissioned by the incoming Whitlam Labour Government. That report noted tax expenditures such as tax relief for life assurance premiums and low rates of tax on life fund earnings. (The subsequent decline in national saving and increased age pension dependency led the later Hawke Government to promote use of superannuation tax concessions).

Subsequently in 1982 the House of Representatives produced a Committee report recommending that Treasury prepare a list and costing of Australian tax expenditures. Treasury were only too happy to do so. Since 1986, the annual tax expenditures statement has appeared. Notwithstanding some cautions in the introduction, this list is usually seen as a list of tax concessions Treasury would prefer to see removed.

The list includes tax concessions for charity notably income tax exemption for charities and deductibility of gifts to a restricted set of charities and other causes. By no means all charities are eligible for deductibility. Religion, in particular, is discriminated against as are schools compared to universities.

Pros and Cons of Tax Expenditures

The major criticism of tax expenditures is that they have a perverse “upside-down effect”, which undermines the redistributive function of a progressive tax system since the level of benefit can depend on the taxpayer’s level of income. Moreover, those without taxable incomes are denied any benefit from tax expenditures.

Also, taxpayers may alter their behaviour in an economically inefficient way in exploiting a tax expenditure largely to avoid tax. The generous tax deductions for investment in Australian films may be an example. Finally, tax expenditures are not subject to the same Budgetary controls as direct Government outlays. Such arguments are often used to suggest that tax deductions should be replaced by tax rebates or credits at a fixed rate or by direct subsidy schemes such as matching grants.

On the other side, tax expenditures have been defended on the following grounds. Treasury in 1986 admitted “In some cases the intention may be to ensure equitable tax treatment for taxpayers in particular circumstances.” Examples could be the tax threshold and family tax benefits.

It has been argued that the decentralised way in which tax expenditure decisions are made - by taxpayers rather than the Government - is an advantage because individual taxpayers’ spending preferences are better accommodated than would be possible via a central bureaucracy. Also, without the need for bureaucratic review, tax expenditures may be cheaper to administer. Professor Martin Feldstein of Harvard University (later Chairman of President Reagan’s Council of Economic Advisers) also argued that a tax expenditure may be successful in stimulating greater overall public and private spending on socially worthwhile activities such as charities.⁶

Because tax expenditures cover such a disparate range of activities, the arguments for or against will vary in strength from case to case. As Treasury officially conceded in its 1986 tax expenditures statement “The inclusion of a particular item in a list of tax expenditures should not be taken to imply a judgement on the merit of its place in the tax system” (original emphasis). Similarly, the House of Representatives Committee concluded that “Each current or proposed taxation expenditure must be examined on its merits.”

The Policy Bias

Unfortunately, qualifications are seldom read. The listing of tax expenditures of itself suggests to most people that these tax subsidies so-called should be replaced by direct expenditures. This policy bias has recently been made even more evident by the rewriting of the gift provisions of the income tax law to group them by Budgetary functional expenditure categories.

⁶ Professor Feldstein’s views stimulated a lot of empirical research in the USA which tended to suggest that tax deductions for charity do lift the overall level of giving.

A critique of the conventional tax expenditure analysis

We have seen that the benchmark tax system should be neutral. This raises the question whether it is neutral for an income tax to ignore voluntary redistribution of income. Should tax be levied on income prior to voluntary redistribution? Business income is taxed net of distributions to creditors and expenses - is it logical to tax individuals without regard to inwards or outwards income transfers?

The public sector is *only one way* for society to meet its welfare needs. Charity is more ancient and, some would say, more honourable. If the public sector finances redistribution through taxes, it is given an advantage compared to private redistribution unless the tax-transfer system recognizes voluntary redistribution. It is *not neutral* for a tax system to ignore voluntary redistribution.

In a pluralistic society, why should not a thousand flowers be allowed to bloom? If maximizing social welfare means recognizing voter preferences, why should they not be undisturbed in promoting those charitable endeavours which most appeal to them? It is after all a test of charity that it be for the public benefit. If people are willing to give money for museums, welfare, hospitals etc there is no efficiency loss to the economy when contrasted with the alternative of tax-financed expenditure on such institutions. Tax concessions for charity are part of an efficient neutral benchmark tax system if one accepts that a neutral tax system should tax private incomes where it finds them.

One has to remember what an income tax is about. Income tax is a tax on persons according to their income. Institutions don't pay tax, people do - hence charities, companies etc should be exempt from income tax. On this reasoning, the income tax exemption for charities is not a tax expenditure at all. If one wants to impose income tax, it should be imposed on the beneficiaries not the charity, just as in the case of normal private trusts. So, if it likes, Treasury should tax the beneficiaries, tax the homeless, the sick, the poor, the helpless, aged and bereft.

Obviously, this might seem a pointless exercise since many of the beneficiaries will be under the tax threshold. In other cases, no concept of income emerges. After all, if government funded research on AIDS does not generate a taxable income to individuals, why should similar research undertaken by private charities be seen as generating taxable income to the community?

It follows that one can reject, even on tax theoretical grounds, the notion that the tax exemption for charities is a departure from a neutral benchmark.

As for tax deductible gifts to charities, one can also question whether these represent tax expenditures.

- First, a business can often claim a business expense deduction for a gift to charity on the basis that it is a promotional expense incurred in gaining public goodwill. No one suggests that such a deduction is a tax expenditure. It is part of the design of the benchmark tax system. Yet why should business taxpayers be better able to support their favoured charities than wage and salary earners?
- Second, what is income? Is income what you earn or control or what you get to enjoy? Henry Simons said income is consumption plus accumulation. But as Professors Oldman and Andrews point out, that means you should tax gifts of income to the recipient, not the donor - you should trace it through to the final consumer of the income. (It is interesting that the Treasury tax expenditures statement does not address this question though the statement claims to follow the Simons concept of income).
- Third, there is absurd arbitrariness in declaring deductibility of charitable gifts as a "tax expenditure" when it is not a tax expenditure for property or business income to be diverted via a trust to a charity. Yet it is a tax expenditure for a poor PAYE taxpayer wanting to contribute to St Vincent de Paul or the Smith Family or the Adventist Church? A neutral benchmark tax system would treat income from personal exertion no worse than property income. Why is it a tax expenditure to allow wage and salary income the same treatment for gifts to charity as is available to property income?

Some may argue that charitable deductions are a tax expenditure because what should be taxed is the ability to control the disposal of income not its actual enjoyment. But that is not how any income tax system is really

designed. If it were so, and the power to dispose of income was a critical marker of a benchmark tax system, then Treasury should be taxing the directors of public companies on the whole of their companies' profits since it is they who have the power to declare a dividend. Similarly discretionary trustees would be taxed on the income of the trusts they control even though they may be excluded from any benefit. Shareholders and beneficiaries would pay no tax, just as children pay no tax on the after-tax income doled out to them as pocket money by parents. Apart from the obvious injustice, this criterion creates absurdities. Presumably no tax would be paid on dividends from companies with foreign directors. Professors Oldman and Andrews are right in noting that when it comes to income transfers, the usual benchmark income tax system is hopelessly flawed.

To drive the point home, consider a gift of all a taxpayer's income to the Commonwealth. The taxpayer is still subject to tax on it unless the gift is for purposes of defence. This is a strange benchmark for a tax system. Even the Emperor Caligula was content to take everything offered by his subjects without taxing them for the privilege of making their donations to the fisc. Logically, gifts of income to government should be deductible and, if that is so, gifts to charities should be treated the same way.

It is thus very hard to accept the oft-repeated but unreflective view that deductibility for charitable gifts represents a tax subsidy.

Conclusion

George Orwell realized that to control language is to control thought. Terms such as "tax expenditure", "tax subsidy" and "tax assistance" are loaded with implicit value judgments. But one needs to examine the underlying benchmark tax system, before making a judgement on what is really a subsidy. The tax expenditure concept has been used as a convenient crutch for those who wish to argue that all tax exemptions are subsidies and *a priori* less efficient than direct outlays. It is a great pity that the misguided analogy of "tax subsidies" or "tax expenditures" has often been used as a substitute for real thought. There are, in truth, strong reasons of equity and efficiency which justify exemptions and deductions for charity in terms of tax theory itself.

At its deepest philosophical level, jurisprudence scholars might well question an apparently implicit totalitarian assumption underneath the "tax expenditure" concept. Lower tax rates can be seen as "tax subsidies" just as much as any tax deduction, so any tax rate less than 100% must, by the same logic, be seen as a "tax subsidy". It is almost as if all the revenue of a country belongs to the Treasury and it is a "concession" that anyone is left with anything to feed and clothe themselves and their families. This is a view of normative tax policy totally contrary to the tradition of English law. It has always been for the Crown to justify its appropriation of any subject's property, and not for the subject to justify his retaining his own property.

The "competitive neutrality" argument against charities

Unfair competition?

Businesses sometimes complain that tax concessions for charities results in "unfair competition". For example, St Vincent de Paul shops are accused of taking shopping dollars away from Woolworths or school canteens accused of taking money away from McDonalds.

Hence, it is argued tax should be imposed on the unrelated business income of charities (assuming, of course, that such a concept can be intelligently defined).

But, as the Industry Commission recognized, this argument is quite shallow. Presumably, a charity running a business is as keen to maximize its profits as anyone else. The more it maximizes profits, the more revenue it can apply to its charitable purposes. Indeed, it has more reason to maximize pre-tax profits - it gets to keep the lot. Why should it give away its tax exemption to customers of a business it runs?

From a practical point of view, the concept of taxing a charity's business income is hopelessly unwieldy. What if a charity lends to its business at a rate of interest varying with profits? What if its interest is as a partner or as a beneficiary in a private trust? There is enough verbiage in the tax law without adding more. Yet that would be the inevitable effect of trying to draw an artificial separation of a charity's income into business and non-business income.

At a strictly logical level, the “unfair competition” argument does not hold up. Does it mean that nobody should ever do anything cheaply or voluntarily for someone else if it would adversely affect a commercial trader’s profits? Are mothers working voluntarily in school canteens “unfair competition” against KFC? On this logic, Parliament would need to pass laws banning mothers from cooking for their children at home instead of taking them to McDonald’s every day.

Presumably, no one takes the argument this far. But as the Industry Commission recognised in 1995, the argument still makes no sense when applied more narrowly to the tax exemption for business income of charities. If charities are deriving business income from arm’s-length activities, they have as much reason to maximise their income from that business as anyone else would have. Just as other differently taxed entities such as foreign investors or superannuation funds seek to maximise the returns from their investments or businesses, so do charities.

Why would charity forego income from its business or investment activities in order to subsidise arm’s-length customers rather than and get as much money as it can to carry out its charitable purposes, be they relieving poverty, educational, health-related or religious?

Parliament recognised there is no force in this argument put forward by commercial interests when it legislated, quite properly, to ensure that any tax on the profits of a company distributed to charity is refunded through imputation credits.

At a deeper level, the argument for commercial competitive neutrality completely misses the point that tax exemptions or deductions for charity are actually neutral in the first place. They are available to everyone, including any business. If a Big W, for example, wanted to enjoy the same tax concessions as a charity, it is very easy. All shareholders have to do is decide they no longer want any dividends and vote to declare a charitable trust for the public benefit over all future profits of the business. Many companies do in fact take advantage of tax deductible charitable donations to either their own foundations or two other charities.

What is a level playing field?

The reality is that all sorts of entities, with all sorts of tax treatment, do compete from time to time. Having a “level playing field” does not mean that all players must weigh or be exactly the same height. Co-operatives, families, large corporations, small partnerships or trusts, and foreign-owned corporations may all compete in the one market: yet all have different tax treatments, with their advantages and disadvantages. I may mend my clothes at home, replace them from St Vincent de Paul or buy at a small retail shop down the street or go to Target or order from overseas over the Internet. Each of these choices has different tax consequences but no one argues that home production, sole traders, partnerships, trusts, co-operatives and foreign and domestic companies should all be taxed the same: it is simply not possible, even if it were desirable (which it is not, as recognized by the government’s rejection of a common entity tax system).

The danger of false level playing field arguments is highlighted when one notes that, in actual fact, charities face some disadvantages in carrying on a business compared, for example, to branches of multinationals. Charities must fund their activities solely through retained earnings or gifts with possibly some borrowing. Charities cannot raise funds through equity; they cannot remit profits offshore through transfer payments or intellectual property licensing or thin capitalization. Charities operate domestically and all their revenues are re-invested in Australian jobs and in providing benefits for the Australian community. A business activity conducted on behalf of an Australian charity may still produce much more overall tax revenue and economic benefit for the Australian community (through onshore economic multiplier effects) than a similar business conducted by a branch or subsidiary of a foreign multinational.

Ensuring ethical competition

Competitive markets are not always ethical or moral. A perfect market in economic theory requires perfect knowledge on the part of consumers. Often consumers do not have such perfect knowledge, especially where the side-effects of a product or the necessity of a service cannot be easily checked. In such situations, there can

be a temptation for purely profit-centred producers to “cut corners” or behave unethically (e.g. medical over-servicing or selling food of no nutritional value filled up with cheap sweetening and additives).

While legislation is often used to prevent market abuses, it can never be a complete solution and the integrity of the market ultimately depends on the integrity of the market participants. Participation by charities in some markets may help set standards of market integrity. It is understandable that some commercial providers tempted to cut corners might chafe at competition from a charity which holds to certain ethical standards as part of its mission, but it can hardly be said that competition in this way is “unfair”.

Charitable activity in areas such as health can thus act as a check on moral hazard through excessive commercial motivation where the recipient of a service is unable to ascertain whether the provision of a service is necessary. For example, given that the price people would be willing to pay for life is almost infinite, market mechanisms can break down. There are moral temptations for a profit-maximizing supplier of medical or hospital care to over-serve an ignorant or desperate patient. It is in cases such as this that charitable provision can act as an ethical conscience for suppliers of services generally by setting publicly observed standards of good professional practice.

As a matter of historical fact, precisely because trust is required in certain activities such as health, charities were well-established before the entry of commercial “for profit” providers.

REFERENCES

- Andrews, William D (1972) *Personal Deductions in an Ideal Income Tax* **Harvard Law Review** Vol 86, No 2, December 1972, pp 309-385
- (Asprey) Taxation Review Committee (1975) *Full Report* (Asprey Report), Australian Government Publishing Service, Canberra, January 1975
- Bradshaw, F M (1983) *The Law of Charitable Trusts in Australia*, Butterworths, Sydney
- Charitable Trusts Committee, (Rt Hon Lord Nathan, Chairman) UK Parliament (1952) *Report of the Committee on the Law and Practice relating to Charitable Trusts* (Nathan Report), Cmd. 8710, December, London, Her Majesty's Stationery Office
- Commonwealth Treasury (various years) *Tax Expenditures Statement*, Canberra
- Coombs, Dr H C (Chairman) (1973) *Review of the Continuing Expenditure Policies of Previous Government: Report of the Task Force*, Canberra, June
- Cox, James (1992) *Private Welfare*, Centre for Independent Studies, Sydney
- Dal Pont, Gino (2000) *Charity Law in Australia and New Zealand*, Oxford University Press, Melbourne
- Goodman, John C and Nicholas, Alistair J (1990) *Voluntary Welfare: A Greater Role for Private Charities*, Centre for Independent Studies, Sydney
- Industry Commission (1995) *Charitable Organisations in Australia*, Report No. 45, 16 June, Canberra
- Krever, Richard and Kewley, Gretchen, editors, (1991) *Charities and Philanthropic Organisations: Reforming the Tax Subsidy and Regulatory Regimes*, Australian Tax Research Foundation, Sydney
- Kutner, Luis (1970) *Legal Aspects of Charitable Trusts and Foundations*, CCH, Chicago
- Miller, Howard S (1961) *The Legal Foundations of American Philanthropy 1776 – 1844*, State Historical Society of Wisconsin, Madison
- Sheppard, The Hon Ian AO, QC (Chairman) (2000) *Report of the Inquiry into the Definition of Charities and Related Organisations*, Canberra, June 2001
- Simons, Henry (1938) *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy*, University of Chicago Press, 1938
- Smith, Adam (1759) *The Theory of Moral Sentiments*, Liberty Press edition, Indianapolis, 1976
- Surrey, Stanley S (1973) *Pathways to Tax Reform: the Concept of Tax Expenditures*, Harvard University Press, Cambridge, Massachusetts